

FINANCIAL STATEMENTS AND REPORT OF
INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS
HERINGTON MUNICIPAL HOSPITAL
JUNE 30, 2011 AND 2010

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HERINGTON MUNICIPAL HOSPITAL
MANAGEMENT'S DISCUSSION AND ANALYSIS
Years ended June 30, 2011 and 2010

Our discussion and analysis of the financial performance of Herington Municipal Hospital provides a narrative overview of the Hospital's financial activities for the years ended June 30, 2011 and 2010. Please read it in conjunction with the accompanying basic financial statements.

Financial highlights

The Hospital reported an operating gain of \$88,377 in 2011, an operating loss of \$265,787 in 2010, and an operating gain of \$125,298 in 2009. After consideration of other nonoperating revenues and expenses, the Hospital's net assets increased by \$211,288 or 77.4 percent in 2011 and decreased by \$279,671 or 50.6 percent in 2010.

Using these financial statements

The Hospital's financial statements consist of three statements - a Balance Sheet; a Statement of Revenues, Expenses and Changes in Net Assets; and a Statement of Cash Flows. These financial statements and related notes provide information about the activities of the Hospital, and resources held by or for the benefit of the Hospital.

One of the most important questions asked about the Hospital's finances is, "Is the Hospital as a whole better or worse off as a result of the year's activities?" The Balance Sheet and the Statement of Revenues, Expenses and Changes in Net Assets report information about the Hospital's resources and its activities in a way that helps answer this question. These statements include all restricted and unrestricted assets and all liabilities using the accrual basis of accounting. Revenues and expenses are taken into account regardless of when cash is received or paid.

These two statements report the Hospital's net assets and changes in them. The Hospital's net assets - the difference between assets and liabilities may be thought of as one way to measure the financial health, or financial position. Over time, increases or decreases in the Hospital's net assets are one indicator of whether its financial health is improving or deteriorating. Consideration must also be given to other nonfinancial indicators, such as changes in the Hospital's patient base and measures of the quality of service it provides to the community, as well as local economic factors to assess the overall health of the Hospital.

The final required statement is the Statement of Cash Flows. The statement reports cash receipts, cash payments, and net changes in cash resulting from operating, investing, and financing activities. It provides answers to such questions as "Where did cash come from?", "What was cash used for?", and "What was the change in cash balance during the reporting period?"

HERINGTON MUNICIPAL HOSPITAL
MANAGEMENT'S DISCUSSION AND ANALYSIS - CONTINUED
Years ended June 30, 2011 and 2010

Assets, liabilities, and net assets

Table 1 below summarizes the Hospital's assets, liabilities, and net assets for the latest three fiscal years.

Table 1: Assets, Liabilities, and Net Assets

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Assets			
Current assets	\$1,309,361	\$1,180,362	\$1,445,507
Capital assets, net	787,159	1,533,929	1,708,294
Other noncurrent assets	<u>127,624</u>	<u>137,712</u>	<u>136,013</u>
Total assets	<u>2,224,144</u>	<u>2,852,003</u>	<u>3,289,814</u>
Liabilities			
Current liabilities	1,083,014	1,161,261	1,679,596
Noncurrent liabilities	<u>656,721</u>	<u>1,417,621</u>	<u>1,057,426</u>
Total liabilities	<u>1,739,735</u>	<u>2,578,882</u>	<u>2,737,022</u>
Net assets			
Invested in capital assets, net of related debt	585,065	476,502	474,204
Expendable for capital acquisitions	18,654	18,654	
Unrestricted (deficit)	<u>(119,310)</u>	<u>(222,035)</u>	<u>78,588</u>
Total net assets	<u>\$ 484,409</u>	<u>\$ 273,121</u>	<u>\$ 552,792</u>

The most significant change in current assets was an increase in patient accounts receivable. During 2009, there was significant turnover in administrative personnel which led to an increase in patient accounts receivable. In 2010, accounts receivable decreased significantly due to the Hospital writing off old receivables and collecting current receivables more timely than in prior years. The Hospital experienced an increase in net accounts receivable again in 2011. Gross accounts receivables have continued to decrease over the past three years however. Being designated as a critical access hospital, the Hospital is reimbursed for its service to Medicare and Medicaid patients on the basis of the cost of providing the services. These services are paid on an interim basis based on various formulas with final settlement made through an annual cost report filed after the Hospital's year-end. In 2010 and 2011, the cost report reflected a receivable from Medicare and Medicaid.

HERINGTON MUNICIPAL HOSPITAL
MANAGEMENT'S DISCUSSION AND ANALYSIS - CONTINUED
Years ended June 30, 2011 and 2010

The Hospital's capital acquisitions were \$126,956, \$60,535, and \$245,715 during 2011, 2010, and 2009. The acquisitions in 2009 were primarily funded by increases in long-term lease obligations of \$522,750. The 2010 and 2011 capital acquisitions were financed through donations received from the Herington Municipal Hospital Foundation and others and capital lease obligations. Other changes in capital assets, net, results from the normal annual depreciation provisions of \$148,174, \$234,901, and \$256,364 during 2011, 2010, and 2009. The Hospital made principal payments on long-term leases and revenue bonds of \$85,506 in 2011, \$180,103 in 2010, and \$173,532 in 2009. In 2010 and 2009, additional borrowings exceeded payment by \$342,647 and \$64,470 resulting in an increase in noncurrent liabilities. In 2011, the Hospital transferred ownership of the Homestead Village and related debt to the City of Herington, which reduced its noncurrent liabilities and capital equipment by \$855,000 and \$743,358, respectively. The bonds were refinanced in the City of Herington's name, which relieved the Hospital of the debt. The City of Herington loaned the Hospital \$489,000 during 2010 to help pay current obligations of the Hospital. As of June 30, 2011, the Hospital owes the City a total of \$857,649 of which \$509,000 is classified as long-term.

Other noncurrent assets consist primarily of board-designated funds that are available to fund the continuing operation of the Hospital and funds for the Hospital's self-funded portion of its employees' health insurance deductibles. These funds increased by approximately \$7,718 in 2011 and increased by approximately \$4,500 in 2010. In 2008, the Hospital used its operating cash, investments, and \$30,000 of monies borrowed from the City of Herington to make timely payments of its bond principal and interest. Of the \$30,000 borrowed from the City in 2008, \$20,000 remained unpaid at June 30, 2011.

Current liabilities consist of balances accrued or currently due to suppliers, vendors, employees, and government agencies, related to operations and accrued interest on indebtedness and principal on indebtedness that will come due within one year. Accrued interest, accrued salaries and benefits, and accrued compensated absences fluctuate with operation and the timing of payments.

In 2010, accounts payable decreased by \$240,956 and the current amount due to the City of Herington increased by \$115,874. In 2011, accounts payable decreased by \$116,919 and the current amount due to the City of Herington increased by \$131,809. In 2009, the estimated third-party payor settlement increased by \$346,302, which was primarily due to Medicare interim payment for services in excess of the cost of providing services to Medicare beneficiaries. In 2010, the Hospital paid Medicare \$427,305 from the proceeds of the long-term loan from the City of Herington. At June 30, 2010 and 2011, the Hospital has a net receivable from Medicare and Medicaid of \$220,502 and \$189,957, respectively.

HERINGTON MUNICIPAL HOSPITAL
MANAGEMENT'S DISCUSSION AND ANALYSIS - CONTINUED
Years ended June 30, 2011 and 2010

Operating results and changes in net assets

In 2011, the Hospital's net assets increased by \$211,288 or 77.4 percent. This change is made up of different components as displayed below in Table 2.

Table 2: Operating Results and Changes in Net Assets

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Operating revenues			
Net patient service revenue	\$6,183,270	\$6,006,690	\$6,330,690
Independent living revenue	22,644	184,778	198,609
Other operating revenue	<u>121,670</u>	<u>84,447</u>	<u>120,929</u>
Total operating revenues	<u>6,327,584</u>	<u>6,275,915</u>	<u>6,650,228</u>
Operating expenses			
Salaries and wages	3,061,066	2,999,092	2,727,751
Employee benefits	501,451	480,905	437,930
Supplies and other	2,528,516	2,826,804	3,102,885
Depreciation	<u>148,174</u>	<u>234,901</u>	<u>256,364</u>
Total operating expenses	<u>6,239,207</u>	<u>6,541,702</u>	<u>6,524,930</u>
Operating gain (loss)	88,377	(265,787)	125,298
Nonoperating expenses net of revenues	(45,007)	(93,373)	(81,553)
Gain on sale of Homestead Homestead Village to City	127,865		
Capital grants and contributions	<u>40,053</u>	<u>79,489</u>	
Increase (decrease) in net assets	<u>\$ 211,288</u>	<u>\$ (279,671)</u>	<u>\$ 43,745</u>

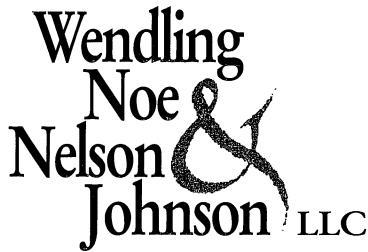
The first component of the overall change in the Hospital's net assets is its operating gain or loss - generally the difference between net patient service revenue and other operating revenues and the expenses incurred to generate those revenues. In 2011, the Hospital's operating gain was \$88,377, an increase of \$354,164 from its operating loss for 2010. In 2010, the Hospital's operating loss increased by \$391,085 in comparison to 2009, while in 2009, the operating gain increased by \$1,154,710 in comparison to 2008. The Hospital's net patient service revenue in 2011 increased \$176,580 or 2.9 percent. In 2010, net patient service revenues decreased \$324,000 or 5.1 percent and, in 2009, increased by 45.5 percent over the previous year. The change in net patient service revenue is affected by changes in charges to patients, payment rates by third-party payors, patient volumes, the type of services provided, bad debts, and the change in Medicare and Medicaid reimbursement. The increase in 2011 was due to an increase in patient utilization. Acute inpatient days increased by 13 percent in 2011 compared to 2010 and swing-bed days increased by 8 percent. The decrease in 2010 was due to a decrease in patient utilization, partially offset by an increase in rates. Acute inpatient days increased by 19 percent in 2010 as compared to 2009 and swing-bed days decreased by 21 percent. The most

HERINGTON MUNICIPAL HOSPITAL
MANAGEMENT'S DISCUSSION AND ANALYSIS - CONTINUED
Years ended June 30, 2011 and 2010

significant factor in the 2010 decrease in net revenues was the increase in contractual adjustments from third-party payors which increased by \$302,342. This amount included a reduction in the estimated settlement of the Hospital's 2009 Medicare cost report of \$75,000. Other factors contributing to the decrease were a \$127,998 decrease in gross charges to patients for service rendered. Operating expenses decreased by \$302,495 or 4.6 percent from 2010 to 2011, and were very stable from 2009 to 2010, increasing by \$16,772 or .26 percent. Reducing operating expenses in 2011 was a major priority of the Hospital.

Nonoperating revenues (expenses) include interest expense and investment income earned on investments. Interest expense increased in 2011 due to the Hospital entering into additional lease obligations and interest incurred on outstanding accounts payable balances and decreased due to the transfer of the Hospital's Series 1999 revenue bonds to the City.

This financial report is designed to provide a general overview of the Hospital's finances and to discuss the significant changes in our financial statements. If you have any questions about the report or need additional financial information, contact the Administration Office at Herington Municipal Hospital, 100 East Helen, Herington, Kansas 67449.



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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Trustees
Herington Municipal Hospital

We have audited the accompanying financial statements of the business-type activity of Herington Municipal Hospital, component unit of the City of Herington, Kansas, and the discretely presented component unit as of and for the years ended June 30, 2011 and 2010, which collectively comprise the Hospital's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Hospital's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the Kansas Municipal Audit Guide. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Hospital's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the business-type activity of Herington Municipal Hospital and the discretely presented component unit as of June 30, 2011 and 2010, and the results of their operations, changes in net assets and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying Hospital financial statements have been prepared assuming that the Hospital will continue as a going concern. As discussed in Note M to the financial statements, the Hospital's history of operating losses and negative cash flows raise substantial doubt about its ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Hospital management's discussion and analysis on pages 1 through 5 is not a required part of the basic financial statements but is required supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Wendling Nae Nelson & Johnson LLC

Topeka, Kansas
February 1, 2012

FINANCIAL STATEMENTS

HERINGTON MUNICIPAL HOSPITAL

BALANCE SHEETS

June 30,

ASSETS

	2011		2010	
	<u>Hospital</u>	<u>Component unit</u>	<u>Hospital</u>	<u>Component unit</u>
CURRENT ASSETS				
Cash	\$ 20,599	\$ 50,242	\$ 7,814	\$ 39,692
Patient accounts receivable, net	890,109		784,633	
Other receivables	7,533		(283)	
Estimated third-party payor settlements	189,957		220,502	
Inventories	145,505		119,617	
Prepaid expenses	55,658		48,079	
Total current assets	<u>1,309,361</u>	<u>50,242</u>	<u>1,180,362</u>	<u>39,692</u>
ASSETS LIMITED AS TO USE				
By Board of Trustees				
For capital assets	109,249		119,906	
For health claims	18,375			
By Donors		7,992		17,244
Total assets limited as to use	<u>127,624</u>	<u>7,992</u>	<u>119,906</u>	<u>17,244</u>
CAPITAL ASSETS - NET	<u>787,159</u>	<u>-</u>	<u>1,533,929</u>	<u>-</u>
OTHER ASSETS				
Bond financing costs, net of accumulated amortization of \$39,184 in 2010	<u>-</u>	<u>-</u>	<u>17,806</u>	<u>-</u>
Total assets	<u>\$ 2,224,144</u>	<u>\$ 58,234</u>	<u>\$ 2,852,003</u>	<u>\$ 56,936</u>

The accompanying notes are an integral part of these statements.

LIABILITIES AND NET ASSETS

	2011		2010	
	<u>Hospital</u>	<u>Component unit</u>	<u>Hospital</u>	<u>Component unit</u>
CURRENT LIABILITIES				
Current portion of long-term debt and capital lease obligations	\$ 79,110	\$ -	\$ 159,116	\$ -
Accounts payable	428,647		545,566	880
Accrued salaries, wages, and benefits	114,443		105,147	
Due to City of Herington	348,649		216,840	
Deferred revenue			4,000	
Accrued compensated absences	97,731		103,210	
Accrued interest payable	14,434		27,382	
Total current liabilities	<u>1,083,014</u>	<u>-</u>	<u>1,161,261</u>	<u>880</u>
LONG-TERM DEBT AND CAPITAL LEASES, net of current portion				
Revenue bonds			780,000	
Capital lease obligations	147,721		148,621	
Due to City of Herington	509,000		489,000	
Total long-term liabilities	<u>656,721</u>	<u>-</u>	<u>1,417,621</u>	<u>-</u>
Total liabilities	<u>1,739,735</u>	<u>-</u>	<u>2,578,882</u>	<u>880</u>
NET ASSETS				
Invested in capital assets - net of related debt	585,065		476,502	
Expendable for capital acquisitions	18,654	7,992	18,654	17,244
Unrestricted (deficit)	(119,310)	50,242	(222,035)	38,812
Total net assets	<u>484,409</u>	<u>58,234</u>	<u>273,121</u>	<u>56,056</u>
Total liabilities and net assets	<u>\$ 2,224,144</u>	<u>\$ 58,234</u>	<u>\$ 2,852,003</u>	<u>\$ 56,936</u>

HERINGTON MUNICIPAL HOSPITAL
STATEMENTS OF REVENUES, EXPENSES AND
CHANGES IN NET ASSETS
Year ended June 30,

	2011		2010	
	<u>Hospital</u>	<u>Component unit</u>	<u>Hospital</u>	<u>Component unit</u>
Operating revenues				
Net patient service revenue	\$ 6,183,270	\$ -	\$ 6,006,690	\$ -
Independent living	22,644		184,778	
Other	<u>121,670</u>	<u>47,041</u>	<u>84,447</u>	<u>117,835</u>
Total operating revenues	<u>6,327,584</u>	<u>47,041</u>	<u>6,275,915</u>	<u>117,835</u>
Operating expenses				
Salaries and wages	3,061,066		2,999,092	
Employee benefits	501,451		480,905	
Supplies and other	2,528,516	44,863	2,826,804	61,779
Depreciation and amortization	<u>148,174</u>		<u>234,901</u>	
Total operating expenses	<u>6,239,207</u>	<u>44,863</u>	<u>6,541,702</u>	<u>61,779</u>
Operating gain (loss)	<u>88,377</u>	<u>2,178</u>	<u>(265,787)</u>	<u>56,056</u>
Nonoperating revenues (expenses)				
Interest income			315	
Interest expense	(46,814)		(94,188)	
Gain on sale of capital assets	<u>1,807</u>		<u>500</u>	
Total nonoperating revenues (expenses)	<u>(45,007)</u>	<u>-</u>	<u>(93,373)</u>	<u>-</u>
Excess of revenues over expenses (expenses over revenues) before capital grants and contributions	43,370	2,178	(359,160)	56,056
Capital grants and contributions	40,053		79,489	
Gain on sale of Homestead Village to City	<u>127,865</u>			
Increase (decrease) in net assets	211,288	2,178	(279,671)	56,056
Net assets, beginning of year	<u>273,121</u>	<u>56,056</u>	<u>552,792</u>	
Net assets, end of year	<u>\$ 484,409</u>	<u>\$ 58,234</u>	<u>\$ 273,121</u>	<u>\$ 56,056</u>

The accompanying notes are an integral part of these statements.

HERINGTON MUNICIPAL HOSPITAL

STATEMENTS OF CASH FLOWS

Year ended June 30,

	2011		2010	
	<u>Hospital</u>	<u>Component unit</u>	<u>Hospital</u>	<u>Component unit</u>
Cash flows from operating activities				
Receipts from and on behalf of patients	\$ 6,108,339	\$ -	\$ 5,899,671	\$ -
Payments to or on behalf of employees	(3,577,075)		(3,510,555)	
Payments for supplies and services	(2,547,093)	(45,743)	(2,940,954)	(60,899)
Other receipts and payments	<u>132,498</u>	<u>47,041</u>	<u>276,089</u>	<u>117,835</u>
Net cash provided (used) by operating activities	<u>116,669</u>	<u>1,298</u>	<u>(275,749)</u>	<u>56,936</u>
Cash flows from noncapital financing activities				
Interest paid	<u>(25,719)</u>	<u>-</u>	<u>(13,575)</u>	<u>-</u>
Cash flows from capital and related financing activities				
Acquisition of capital assets	(126,956)		(60,536)	
Grants and contributions for capital	40,053		79,489	
Proceeds from issuance of debt	99,600		522,750	
Principal payments on long-term debt	(85,506)		(180,103)	
Interest paid on capital related debt	<u>(17,820)</u>	<u>-</u>	<u>(67,960)</u>	<u>-</u>
Net cash provided (used) by capital and related financing activities	<u>(90,629)</u>	<u>-</u>	<u>293,640</u>	<u>-</u>
Cash flows from investing activities				
(Increase) decrease in assets limited as to use	10,657		(4,499)	
Interest received			315	
Proceeds from sale of capital assets	<u>1,807</u>	<u>-</u>	<u>500</u>	<u>-</u>
Net cash provided (used) by investing activities	<u>12,464</u>	<u>-</u>	<u>(3,684)</u>	<u>-</u>
Increase in cash and cash equivalents	12,785	1,298	632	56,936
Cash and cash equivalents at beginning of year	<u>7,814</u>	<u>56,936</u>	<u>7,182</u>	<u>-</u>
Cash and cash equivalents at end of year	<u>\$ 20,599</u>	<u>\$ 58,234</u>	<u>\$ 7,814</u>	<u>\$ 56,936</u>

The accompanying notes are an integral part of these statements.

HERINGTON MUNICIPAL HOSPITAL
STATEMENTS OF CASH FLOWS - CONTINUED
Year ended June 30,

	2011		2010	
	<u>Hospital</u>	<u>Component unit</u>	<u>Hospital</u>	<u>Component unit</u>
Reconciliation of operating gain (loss) to net cash provided (used) by operating activities				
Operating gain (loss)	\$ 88,377	\$ 2,178	\$ (265,787)	\$ 56,056
Adjustments to reconcile operating gain (loss) to net cash provided (used) by operating activities				
Depreciation	148,174		234,901	
Provision for bad debts	268,162		400,684	
Change in				
Patient accounts receivable	(373,638)		67,799	
Inventories	(25,888)		15,077	
Other current assets and assets limited as to use for health claims	(33,770)		2,718	
Accounts payable and accrued expenses	18,707	(880)	(271,513)	880
Estimated third-party payor settlements	30,545		(575,502)	
Due to City of Herington			115,874	
Deferred revenue	(4,000)			
Net cash provided (used) by operating activities	<u>\$ 116,669</u>	<u>\$ 1,298</u>	<u>\$ (275,749)</u>	<u>\$ 56,936</u>

Supplemental schedule of noncash investing and financing activities

The Hospital entered into capital lease obligations for equipment totaling \$79,600 in 2011 and \$33,750 in 2010.

The accompanying notes are an integral part of these statements.

HERINGTON MUNICIPAL HOSPITAL
NOTES TO FINANCIAL STATEMENTS
June 30, 2011 and 2010

NOTE A - DESCRIPTION OF REPORTING ENTITY AND SUMMARY OF SIGNIFICANT
ACCOUNTING POLICIES

1. Reporting entity

Herington Municipal Hospital (Hospital), a political subdivision of the State of Kansas, is located in Herington, Kansas, and was organized for the purpose of providing health care services to patients on an inpatient and outpatient basis. The Hospital also provided independent living service until August 10, 2010, when it transferred its independent living facility to the City of Herington. The Hospital is governed by a five-member Board of Trustees elected by the voters of the City. The Hospital can sue and be sued, and can buy, sell, or lease real property. Bond issuances must be approved by the City. The Hospital is a discretely presented component unit of the City of Herington, Kansas, for financial statement purposes. The Hospital is licensed as a Critical Access Hospital (CAH) with a bed capacity of 25 beds.

2. Component unit

The financial statements include the financial data of the discretely presented component unit, Herington Municipal Hospital Foundation (Foundation). The component unit is reported separately to emphasize that it is legally separate from the Hospital.

The Foundation is recognized by the Internal Revenue Service as a 501(c)(3) Corporation, incorporated in the State of Kansas on August 7, 2001. The Foundation was originally formed for the purpose of acquiring a long-term care unit. In 2006, the name was changed to Herington Municipal Hospital Foundation. The Foundation was inactive from 2006 until it was re-established in December 2009. The Foundation was established as a public charitable foundation with the mission of raising funds for the Hospital. The Foundation is administered by a self-perpetuating Board of Directors which is appointed by the Hospital who is the sole member of the Foundation. Separate financial statements of the Foundation are not available.

3. Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

4. Basis of accounting

The Hospital's financial statements are comprised solely of an enterprise fund that uses proprietary fund accounting. The Hospital utilizes the proprietary fund method of accounting whereby revenue and expenses are recognized on the accrual basis using the economic resources measurement focus. Based on Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, as amended, the Hospital has elected to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB), including those issued after November 30, 1989, that do not conflict with or contradict GASB pronouncements.

HERINGTON MUNICIPAL HOSPITAL
NOTES TO FINANCIAL STATEMENTS - CONTINUED
June 30, 2011 and 2010

NOTE A - DESCRIPTION OF REPORTING ENTITY AND SUMMARY OF SIGNIFICANT
ACCOUNTING POLICIES - Continued

5. Cash and cash equivalents

Hospital cash and cash equivalents include all cash and highly liquid debt instruments purchased with a maturity of three months or less, excluding any such amounts included in assets limited as to use. Component unit cash and cash equivalents include all cash and highly liquid debt instruments purchased with a maturity of three months or less.

6. Allowance for uncollectible accounts

The Hospital provides for accounts receivable that could become uncollectible in the future by establishing an allowance to reduce the carrying value of such receivables to their estimated net realizable value. The Hospital estimates this allowance based on the aging of its accounts receivable and its historical collection experience for each type of payor.

7. Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

8. Assets limited as to use

Assets limited as to use include cash set aside by the Board of Trustees for purchase of capital assets and for payment of partially self-insured health claims, over which the Board retains control and may at its discretion subsequently use for other purposes; and cash restricted as to use by donors.

9. Capital assets

Capital assets (including assets recorded as capital leases) are stated at cost. Depreciation and amortization of capital assets are provided on the straight-line method over the estimated useful lives of the assets. The estimated lives used are substantially in conformity with useful life guidelines established by the American Hospital Association.

The costs of maintenance and repairs are charged to operating expenses as incurred. The costs of significant additions, renewals, and betterments to depreciable properties are capitalized and depreciated over the remaining or extended estimated useful lives of the items or the properties. Gains and losses on disposition of capital assets are included in nonoperating revenues and expenses.

10. Bond financing costs

Bond financing costs are amortized over the life of the bonds using the interest method.

HERINGTON MUNICIPAL HOSPITAL
NOTES TO FINANCIAL STATEMENTS - CONTINUED
June 30, 2011 and 2010

NOTE A - DESCRIPTION OF REPORTING ENTITY AND SUMMARY OF SIGNIFICANT
ACCOUNTING POLICIES - Continued

11. Net assets

Net assets of the Hospital are classified in three components. "Net assets invested in capital assets net of related debt" consist of capital assets net of accumulated depreciation and reduced by the balances of any outstanding borrowings used to finance the purchase or construction of those assets. "Restricted expendable net assets" consist of noncapital net assets that must be used for a particular purpose, as specified by creditors, grantors, or contributors external to the Hospital, including amount deposited with trustees as required by revenue bond indentures. "Unrestricted net assets" are remaining net assets that do not meet the definition of "invested in capital assets net of related debt" or "restricted expendable net assets."

12. Net patient service revenue

Net patient service revenue is reported at established charges with deductions for discounts, charity care, contractual adjustments, and provision for bad debts, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined.

13. Charity care

The Hospital provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than its established rates. Because the Hospital does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. The identified amount of charges foregone for services and supplies furnished under the Hospital's charity care policy aggregated \$42,571 and \$25,955 in 2011 and 2010, respectively.

14. Income taxes

The Hospital is exempt from federal income taxes pursuant to Section 115 of the Internal Revenue Code.

HERINGTON MUNICIPAL HOSPITAL
NOTES TO FINANCIAL STATEMENTS - CONTINUED
June 30, 2011 and 2010

NOTE B - NET PATIENT SERVICE REVENUE

The Hospital has agreements with third-party payors that provide for payments to the Hospital at amounts different from its established charge rates. The amounts reported on the balance sheet as estimated third-party payor settlements consist of the estimated differences between the contractual amounts for providing covered services and the interim payments received for those services. A summary of the payment arrangements with major third-party payors follows:

Medicare - The Hospital is a critical access hospital for purposes of the Medicare program and is paid for services rendered to Medicare beneficiaries under various cost reimbursement methodologies. The Hospital is paid for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by the Hospital and audits or reviews thereof by the Medicare fiscal intermediary. The Hospital's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review by a peer review organization. The Hospital's Medicare cost reports have been audited or reviewed by the Medicare fiscal intermediary through June 30, 2010.

Medicaid - Inpatient and outpatient services rendered to traditional Medicaid beneficiaries are paid under a cost reimbursement methodology that is similar to the Medicare program. All other Hospital services rendered to Medicaid beneficiaries are paid at prospective rates determined on a rate per discharge, a per diem, or a fee-for-service basis. The Hospital's Medicaid cost reports have been audited or reviewed by the Kansas Health Policy Authority through June 30, 2009.

The Hospital has also entered into payment agreements with certain commercial insurance carriers and preferred provider organizations. The basis for payment to the Hospital under these agreements includes prospectively determined case rates and discounts from established charges.

A summary of gross and net patient service revenue follows:

	<u>2011</u>	<u>2010</u>
Gross patient service revenue	\$ 8,584,268	\$ 9,068,705
Contractual adjustments	(1,992,629)	(2,567,202)
Discounts	(97,636)	(68,174)
Charity care	(42,571)	(25,955)
Provision for bad debts	<u>(268,162)</u>	<u>(400,684)</u>
Net patient service revenue	<u>\$ 6,183,270</u>	<u>\$ 6,006,690</u>

HERINGTON MUNICIPAL HOSPITAL
NOTES TO FINANCIAL STATEMENTS - CONTINUED
June 30, 2011 and 2010

NOTE B - NET PATIENT SERVICE REVENUE - Continued

Revenue from the Medicare and Medicaid programs accounted for approximately 60 percent and 4 percent, respectively, of the Hospital's net patient service revenue during 2011, and 53 percent and 3 percent, respectively, of the Hospital's net patient service revenue during 2010. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

NOTE C - DEPOSITS WITH FINANCIAL INSTITUTIONS

Kansas statutes authorize the Hospital, with certain restrictions, to deposit or invest in open accounts, time deposits, certificates of deposit, repurchase agreements, U.S. Treasury bills and notes, and the State Treasurer's investment pool. Kansas statutes also require that collateral be pledged and deposited with designated depositories for bank deposits with a fair market value equal to 100 percent of the uninsured amounts, and must be assigned for the benefit of the Hospital.

At June 30, 2011, the carrying amount of the Hospital's bank deposits was \$148,003 and the bank balances were \$214,077. The bank balances are covered by federal depository insurance.

The Hospital's bank deposits are included in the financial statements under the following categories:

Cash	\$ 20,379
Assets limited as to use	<u>127,624</u>
Total bank deposits	<u>\$ 148,003</u>

NOTE D - PATIENT ACCOUNTS RECEIVABLE

Patient accounts receivable consist of the following:

	<u>2011</u>	<u>2010</u>
Patient accounts receivable	\$ 1,568,158	\$ 1,714,406
Less:		
Allowance for contractual adjustments	(238,690)	(419,175)
Allowance for uncollectible accounts	<u>(439,359)</u>	<u>(510,598)</u>
	<u>\$ 890,109</u>	<u>\$ 784,633</u>

HERINGTON MUNICIPAL HOSPITAL
NOTES TO FINANCIAL STATEMENTS - CONTINUED
June 30, 2011 and 2010

NOTE E - ASSETS LIMITED AS TO USE

Assets limited as to use, held by the Foundation, are carried at fair value and consist of the following:

	<u>2011</u>	<u>2010</u>
Cash	<u>\$ 7,992</u>	<u>\$ 17,244</u>

The composition of Hospital assets limited as to use by Board of Trustees is as follows:

	<u>2011</u>	<u>2010</u>
Cash	<u>\$127,624</u>	<u>\$119,906</u>

NOTE F - CAPITAL ASSETS

Capital asset additions, retirements, and balances are as follows:

	<u>2011</u>			
	<u>Beginning balance</u>	<u>Additions</u>	<u>Retirements</u>	<u>Ending balance</u>
Land	\$ 26,813	\$ -	\$ -	\$ 26,813
Land improvements	81,141		31,538	49,603
Buildings	2,311,733	15,051	738,795	1,587,989
Fixed equipment	1,583,724	87,817	583,615	1,087,926
Movable equipment	<u>2,018,408</u>	<u>24,088</u>	<u>4,074</u>	<u>2,038,422</u>
Totals at historical cost	<u>6,021,819</u>	<u>126,956</u>	<u>1,358,022</u>	<u>4,790,753</u>
Less accumulated depreciation				
Land improvements	77,316	3,224	31,473	49,067
Buildings	1,404,352	30,288	197,508	1,237,132
Fixed equipment	1,315,978	16,434	400,585	931,827
Movable equipment	<u>1,690,244</u>	<u>98,228</u>	<u>2,904</u>	<u>1,785,568</u>
	<u>4,487,890</u>	<u>148,174</u>	<u>632,470</u>	<u>4,003,594</u>
Capital assets, net	<u>\$1,533,929</u>	<u>\$ (21,218)</u>	<u>\$ 725,552</u>	<u>\$ 787,159</u>

HERINGTON MUNICIPAL HOSPITAL
NOTES TO FINANCIAL STATEMENTS - CONTINUED
June 30, 2011 and 2010

NOTE F - CAPITAL ASSETS - Continued

	2010			
	<u>Beginning balance</u>	<u>Additions</u>	<u>Retirements</u>	<u>Ending balance</u>
Land	\$ 26,813	\$ -	\$ -	\$ 26,813
Land improvements	81,141			81,141
Buildings	2,273,526	38,207		2,311,733
Fixed equipment	1,562,983	22,328	1,587	1,583,724
Movable equipment	<u>2,018,408</u>			<u>2,018,408</u>
Totals at historical cost	<u>5,962,871</u>	<u>60,535</u>	<u>1,587</u>	<u>6,021,819</u>
Less accumulated depreciation				
Land improvements	72,743	4,573		77,316
Buildings	1,355,697	48,655		1,404,352
Fixed equipment	1,270,113	47,452	1,587	1,315,978
Movable equipment	<u>1,556,024</u>	<u>134,220</u>		<u>1,690,244</u>
	<u>4,254,577</u>	<u>234,900</u>	<u>1,587</u>	<u>4,487,890</u>
Capital assets, net	<u>\$1,708,294</u>	<u>\$ (174,365)</u>	<u>\$ -</u>	<u>\$1,533,929</u>

Capital assets include the following property under capital leases at June 30:

	<u>2011</u>	<u>2010</u>
Equipment	\$ 568,177	\$ 480,360
Less accumulated amortization	<u>346,532</u>	<u>279,595</u>
	<u>\$ 221,645</u>	<u>\$ 200,765</u>

HERINGTON MUNICIPAL HOSPITAL
NOTES TO FINANCIAL STATEMENTS - CONTINUED
June 30, 2011 and 2010

NOTE G - LONG-TERM DEBT AND CAPITAL LEASES

Long-term debt and capital lease obligations are summarized as follows:

	<u>2011</u>	<u>2010</u>
5.60% - 5.75% City of Herington, Kansas Hospital Revenue Bonds, Series 1999 (Herington Municipal Hospital); issued on March 1, 1999, in the original amount of \$1,400,000 term bonds due serially through March 1, 2009, and term bonds due March 1, 2014 and March 1, 2019, with mandatory annual redemptions beginning March 1, 2010 and March 1, 2015; transferred to City of Herington August 10, 2010	\$ -	\$ 855,000
Noninterest bearing loan from the City of Herington	509,000	489,000
Capital lease obligations	<u>226,831</u>	<u>232,737</u>
	735,831	1,576,737
Less current portion	<u>79,110</u>	<u>159,116</u>
Noncurrent portion	<u>\$ 656,721</u>	<u>\$1,417,621</u>

On August 10, 2010, the City of Herington Public Building Commission issued \$950,000 in Revenue Bonds, Series 2010, to refund the Series 1999 Hospital Revenue Bonds issued March 1, 1999. The City of Herington is responsible for all future principal and interest payments. As part of the refunding, the Hospital transferred ownership of the Homestead Village to the City of Herington on August 1, 2010. The carrying value of the assets transferred and written off as a result of this transaction was \$743,358, and the debt paid by the City of Herington from the proceeds of the City of Herington debt was \$855,000.

HERINGTON MUNICIPAL HOSPITAL
NOTES TO FINANCIAL STATEMENTS - CONTINUED
June 30, 2011 and 2010

NOTE G - LONG-TERM DEBT AND CAPITAL LEASES - Continued

Long-term debt activity for the years ended June 30, is as follows:

2011						
	<u>Beginning balance</u>	<u>Additions</u>	<u>Deletions</u>	<u>Ending balance</u>	<u>Amounts due within one year</u>	<u>Long-term portion</u>
1999 revenue						
bonds payable	\$ 855,000	\$ -	\$ (855,000)	\$ -	\$ -	\$ -
Loan from City						
of Herington	489,000	20,000		509,000		509,000
Capital leases	<u>232,737</u>	<u>79,600</u>	<u>(85,506)</u>	<u>226,831</u>	<u>79,110</u>	<u>147,721</u>
	<u>\$1,576,737</u>	<u>\$ 99,600</u>	<u>\$ (940,506)</u>	<u>\$ 735,831</u>	<u>\$ 79,110</u>	<u>\$ 656,721</u>
2010						
	<u>Beginning balance</u>	<u>Additions</u>	<u>Deletions</u>	<u>Ending balance</u>	<u>Amounts due within one year</u>	<u>Long-term portion</u>
1999 revenue						
bonds payable	925,000	\$ -	\$ (70,000)	\$ 855,000	\$ 75,000	\$ 780,000
Loan from City						
of Herington		489,000		489,000		489,000
Capital leases	<u>309,090</u>	<u>33,750</u>	<u>(110,103)</u>	<u>232,737</u>	<u>84,116</u>	<u>148,621</u>
	<u>\$1,234,090</u>	<u>\$522,750</u>	<u>\$ (180,103)</u>	<u>\$1,576,737</u>	<u>\$159,116</u>	<u>\$1,417,621</u>

The following is a yearly schedule of future minimum lease payments under capital lease obligations at June 30, 2011:

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2012	\$ 79,110	\$ 14,137	\$ 93,247
2013	57,946	8,689	66,635
2014	53,041	4,146	57,187
2015	20,856	1,406	22,262
2016	<u>15,878</u>	<u>399</u>	<u>16,277</u>
Total minimum lease payments	<u>\$ 226,831</u>	<u>\$ 28,777</u>	<u>\$ 255,608</u>

The loan from the City of Herington has no scheduled repayment terms and is based on the Hospital's ability to repay.

HERINGTON MUNICIPAL HOSPITAL
NOTES TO FINANCIAL STATEMENTS - CONTINUED
June 30, 2011 and 2010

NOTE G - LONG-TERM DEBT AND CAPITAL LEASES - Continued

Total interest costs are summarized as follows:

	<u>2011</u>	<u>2010</u>
Interest incurred	\$ 46,814	\$ 91,388
Amortization of deferred financing cost	<u> </u>	<u>2,800</u>
Interest expense	<u>\$ 46,814</u>	<u>\$ 94,188</u>

NOTE H - PENSION PLAN

The Hospital maintains a contributory pension plan for all eligible employees. Eligibility is established by all employees 21 years of age or older who have completed 1,000 hours of service for the year. Employer and employee contributions are computed at the rate of 3.5 percent of annual employee compensation, respectively. Past service cost is funded on an installment basis over the estimated duration of employment from the effective date of the plan (July 1, 1982) to the employee's normal retirement date. Employer contributions vest after five years of service with 100 percent vesting after fifteen years of service. Employee contributions are always fully vested. The total cost of the plan for the years ended June 30, 2011 and 2010, was \$99,569 and \$78,336, respectively. All funds contributed by the Hospital for terminated employees who are not vested are maintained by the pension trustee.

NOTE I - CONCENTRATION OF CREDIT RISK

The Hospital grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements. The mix of patient accounts receivable from patients and third-party payors is summarized as follows:

	<u>2011</u>	<u>2010</u>
Medicare	32.0%	32.0%
Medicaid	7.0	11.0
Blue Cross	6.0	7.0
Commercial	16.0	14.0
Self pay	<u>39.0</u>	<u>36.0</u>
	<u>100.0%</u>	<u>100.0%</u>

HERINGTON MUNICIPAL HOSPITAL
NOTES TO FINANCIAL STATEMENTS - CONTINUED
June 30, 2011 and 2010

NOTE J - RISK MANAGEMENT

The Hospital is insured for professional liability under a comprehensive hospital liability policy provided by an independent insurance carrier with limits of \$200,000 per occurrence up to an annual aggregate of \$600,000 for all claims made during the policy year. The Hospital is further covered by the Kansas Health Care Stabilization Fund for claims in excess of its comprehensive hospital liability policy up to \$300,000 pursuant to any one judgment or settlement against the Hospital for any one party, subject to an aggregate limitation for all judgments or settlements arising from all claims made in the policy year in the amount of \$900,000. All coverage is on a claims-made basis. The above policies were renewed for the policy period from June 30, 2011 to June 30, 2012. There are known claims and incidents that have been asserted. These claims have been referred to the Hospital's professional liability insurance carrier and are in various stages of processing. It is the opinion of management that losses, if any, will be covered by insurance subject to normal policy deductible limits. It is also possible that other claims may be asserted arising from past services provided.

In addition to the risk disclosed elsewhere in these financial statements and notes thereto, the Hospital is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Hospital purchases commercial insurance for these risks. Settled claims have not exceeded this commercial coverage in any of the past three years.

NOTE K - CONTINGENCY

Effective January 1, 2011, the Hospital established a Health Reimbursement Account (HRA) as defined in Internal Revenue Code Section 105 for purposes of providing reimbursement for eligible medical expenses incurred by participants and/or covered dependents. Under the plan, the employee is responsible for the first \$1,500, and the employee and the Hospital share equally the next \$3,500 of covered costs. Costs in excess of \$5,000 are insured by a third-party insurer. The Hospital's Board of Trustees has designated cash, which it believes is adequate to fund its costs under the terms of the plan, and the Hospital accrues an estimated liability under the plan at the balance sheet date.

NOTE L - RELATED PARTY TRANSACTIONS

During the years ended June 30, 2011 and 2010, the Hospital purchased utilities of \$149,285 and \$184,187, respectively, including late charges, from the City of Herington. The City also loaned the Hospital \$509,000 to help pay current obligations of the Hospital. As of June 30, 2011, the Hospital owes the City a total of \$857,649 of which \$348,649 is reflected on the balance sheet as a current liability due to City of Herington and \$509,000 is reflected as long-term debt.

Herington Municipal Hospital Foundation is a component unit of the Hospital (see Note A2). The Foundation periodically transfers funds to the Hospital to support the Hospital's mission. During 2011 and 2010, the Foundation transferred \$41,395 and \$60,835, respectively, to the Hospital for the purchase of equipment and capital improvements to the building.

HERINGTON MUNICIPAL HOSPITAL
NOTES TO FINANCIAL STATEMENTS - CONTINUED
June 30, 2011 and 2010

NOTE M - REALIZATION OF ASSETS

The accompanying financial statements have been prepared in conformity with generally accepted accounting principles, which contemplate continuation of the Hospital as a going concern. However, the Hospital incurred a significant operating loss of approximately \$1,000,000 for 2008, a gain of approximately \$125,000 in 2009, another significant loss of approximately \$266,000 in 2010 and a gain of approximately \$90,000 in 2011. The Hospital has net assets of \$484,409 at June 30, 2011, and has not generated sufficient cash flows in the past four years.

In view of the matter described in the preceding paragraph, recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon continued operations of the Hospital which, in turn, is dependent upon the Hospital's ability to meet its financing requirements on a continuing basis, to maintain present financing, and to succeed in its future operations. The financial statements do not include any adjustments relating to the recoverability of recorded asset amounts or amounts and classifications of liabilities that might be necessary should the Hospital be unable to continue in existence.

Management has taken action in 2010, 2011, and 2012 to increase profitability and cash flows. These actions include the reduction of operating expenses in 2011, the transfer of its independent units and related debt to the City of Herington, making improvements in its collection of patient accounts to reduce bad debts and enhance cash flows, and continuing to address the challenges of decreasing utilization. The Hospital is also in negotiations with the City of Herington for a Grant and for the forgiveness of a portion of its debt to the City. The Herington Municipal Hospital Foundation is continuing its efforts to raise monies to support the Hospital. Management believes that these actions will enable it to sustain operations and the generation of sufficient cash flows.

NOTE N - SUBSEQUENT EVENTS

The Hospital's management has evaluated all subsequent events through February 1, 2012, the date the financial statements were available to be issued.